

Any method that accurately approximates the Illinois portion of an interstate inter-office channel of a private line can be used in calculating Illinois Telecommunications Excise Tax liability. (This is a PLR.)

August 20, 2002

Dear Xxxxx:

This Private Letter Ruling, issued pursuant to 2 Ill. Adm. Code 1200 (see <http://www.revenue.state.il.us/legalinformation/regs/part1200>), will serve as a rescission of and a replacement for our letters to you dated March 7, 2002 and July 25, 2002. Those letters were in response to your letter to us dated November 20, 2001. This rescission and replacement is the result of conversations with PERSON of your CITY office. Review of your request for a letter ruling dated November 20, 2001 disclosed that all information described in paragraphs 1 through 8 of subsection (b) of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY for the issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither COMPANY nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of your ruling request.

In your letter dated November 20, 2001, you stated and made inquiry as follows:

As you and I discussed recently, we seek a Private Letter Ruling on behalf of COMPANY, interpreting the Illinois Telecommunications Excise Tax, 35 ILCS §630 ('TET' or 'Tax'). Specifically, we seek to confirm that the TET, as applied to the inter-office channel of a private line service, may be levied only on the gross charges for the portion of channel miles that are within Illinois.

FACTS

COMPANY uses an interstate point-to-point 'private line' service provided by CARRIER to connect its communications equipment in IL CITY with its equipment in STATE/CITY. Despite the clear language of the TET statute, which allows taxation of charges only for the in-state portion of an interstate inter-office channel, Carrier erroneously bills Company for Tax on 50% of the entire interstate inter-office channel miles and, presumably, remits the Tax to the state. Company, upon whom this Tax is imposed, seeks to clarify the correct method of apportioning the Tax as it applies to the inter-office channel element of private line services for tax periods 1996 through the present.

The 'Private Line' Service

Carrier's point-to-point 'private line' service provides Company with a direct channel specifically dedicated to Company's use for connection between its IL CITY and STATE/CITY locations.¹ Typical of such services in the industry, availability and pricing are not sensitive to Company's usage or to the traffic of other users in Carrier's network, because Carrier dedicates a specific channel to Company's use.

The communications path is as follows: First, a 'local access loop' connects Company's CITY equipment to Carrier's central office in CITY. Second, an interstate 'inter-office channel' connects Carrier's CITY central office to its STATE/CITY central office. Third, another local access loop connects Carrier's STATE/CITY central office to Company's equipment in STATE/CITY. The local loops are not at issue here. We concern ourselves in this ruling request with the middle portion, the interstate inter-office channel.

Physically, the inter-office channel is provided on a fiber-optic cable. Data transmissions travel from the CITY termination point (Carrier's CITY central office) to the STATE/CITY termination point (Carrier's STATE/CITY central office) without interconnection of any kind with a network or with another circuit.² No switching occurs anywhere along the inter-office channel; the transmission is not 'handed off' or 'dropped' at any point other than at Carrier's central office in either STATE/CITY or CITY.

Tax Treatment by Carrier

As discussed below, the TET statute has a special rule for private line services, applying Tax to 'that portion of the interstate inter-office channel provided within Illinois.' 35 ILCS §630/2(a). Carrier makes no effort, however, to determine what portion of the inter-office channel miles are physically located within Illinois, and to bill Company for Tax on its charges only for that portion.³ In contravention of the statute, Carrier simply bills Company for Tax on a flat 50% of the entire charge for the inter-office channel.

Some other carriers do make an effort to apportion Taxable gross charges between Illinois channel mileage and the channel mileage in the rest of the country, but it appears that some may 'mix apples and oranges.' That is, some carriers base their apportionment fractions on numerators (inter-office channel miles within Illinois) and denominators (total inter-office channel miles from CITY to STATE/CITY) that use mathematically inconsistent units of measurement. When measuring the length of an inter-office channel, two types of mileage may be relevant: air miles ('as the crow flies') and route miles (following the circuit's actual path). If consistent data is not readily available, a carrier might attempt to include Illinois *route* miles in its numerator but CITY-to-STATE/CITY *air* miles in its denominator.⁴

¹ Carrier provides Company with other such private line connections, as well. Each private line is a separate, dedicated channel between two locations.

² Although there are no switching devices anywhere along the inter-office channel, the cable on which the channel runs has devices inserted at intervals along the circuit to boost the signal. These 'repeaters' do not switch, hand-off or drop the signal; they simply amplify and 'clean up' the signal.

³ Carrier also bills Company for Tax based on the gross charges for the CITY local access loop (connecting Company's CITY channel point with Carrier's CITY central office channel point). Tax on this local access loop charge is not at issue in this request.

⁴ We understand that AT&T, for example, has historically determined the portion of an inter-office channel attributable to Illinois based on a fraction that uses an average route miles to the border ('MTB') numerator, and a denominator that is the larger of air miles or the sum of the MTBs for the central office at each termination point. ('Average MTB' examines all possible route distances from a carrier's central office to various points where its circuits exit the state, and computes the average distance.) Comparing route miles to air miles is mathematically incorrect, as is comparing average miles to actual miles. See discussion at issue 2, below.

ISSUES

1. Is application of the TET limited so that gross charges for any portion of a private line's inter-office channel miles beyond the Illinois border may not be taxed?
2. Must every method used for apportioning inter-office channel miles (between the in-state portion and the 'beyond-the-border' portion) use mathematically consistent units of measurement for the numerator and denominator?
3. Are the 'Air Miles' and 'Route Miles' methods both acceptable means of apportioning a private line's inter-office channel, while unacceptable methods include a flat percentage or a fraction that mixes air and route miles?

DISCUSSION

Despite a contrary line of authority (mistakenly applying standards from a superseded version of the statute), the current TET statute unambiguously requires apportionment of private line inter-office channel charges between the 'within Illinois' portion and the beyond-the-border portion. Basic principles of mathematics require consistent units of measurement for numerators and denominators to produce a meaningful fraction. Consequently, either 'Illinois air miles over total air miles' or 'Illinois route miles over total route miles' would be an acceptable apportionment method, while a flat 50% apportionment or a fraction that mixes air and route miles would be unacceptable.

1. **Inter-Office Channel Miles May Not Be Taxed Beyond the Illinois Border**

a) ***TET requires apportionment in this case***

The Illinois Telecommunications Excise Tax is imposed on persons, like Company, receiving or originating interstate telecommunications, at the rate of 7% of the 'gross charge' for those services purchased from carriers. 35 ILCS §630/4.

As a general rule, the TET statute does not require apportionment between the Illinois and non-Illinois portions of interstate telecommunications services.⁵ Since 1989, however, the statute has explicitly required apportionment for one specific type of telecommunications service: the interstate inter-office channel component of private line services.⁶ The statute's unique treatment of private line services appears in the section that defines taxable 'gross charges:'

'Gross charges' for private line service shall include charges imposed at each channel point within this State, charges for the channel mileage between each channel point within this state, and charges for that *portion* of the interstate inter-office channel provided *within Illinois*.

⁵ Instead, in order to prevent double taxation of the same telecommunications service (by Illinois and other states), TET imposes Tax under a 'two out of three' test: The state has jurisdiction to impose Tax if the service is (1) charged to an Illinois service address, and the call either (2) originated in Illinois, or (3) terminated in Illinois. 35 ILCS §630/2(a),(b) and /4. As further protection against double taxation, a credit mechanism is provided. 35 ILCS §630/4. The TET survived a US Supreme Court challenge of unconstitutionality in 1989. *See, Goldberg v. Sweet*, 488 US 252 (1989).

⁶ The TET defines 'private line' to mean 'a dedicated non-traffic sensitive service for a single customer, that entitles the customer to exclusive or priority use of a communications channel or group of channels, from one or more specified locations to one or more other specified locations.' 35 ILCS §630/2(c). The private line service purchased from Carrier by Company provides a dedicated channel for Company's exclusive use between its CITY and STATE/CITY locations, without regard to other network traffic. It falls squarely within the TET definition of 'private line.'

35 ILCS §630/2(a), *emphasis added*.

(b) *The Department has misinterpreted TET*

We respectfully suggest that the Department's earlier Private Letter Rulings and General Information Letters addressing the apportionment of the interstate inter-office channel charges for private lines have partially misinterpreted the TET statute.

As a threshold matter, the Department has properly noted that: (1) the TET statute requires apportionment, and (2) this apportionment must be based on a numerator of Illinois mileage over a denominator of total mileage:

In short, the tax is apportioned on a *distance basis*. This apportionment allocates the communications charges subject to the tax based on the *ratio* of the private line mileage contained in Illinois to the total amount of mileage contained in the private line service.

ST-97-0592-GIL, *emphasis added*. See also, ST-98-0299-GIL. In illustration of this correct interpretation, the Department has explained:

For example, on a private line service from CITY to CITY/STATE, the portion taxable for purposes of the Illinois Telecommunications Excise Tax would be the *distance from the channel point in CITY to the Illinois border ...*

Id., ST-97-0592-GIL and ST-98-0299-GIL, *emphasis added*.

Up to this point, the Department's analysis is consistent with the TET statute. Unfortunately, these two rulings go on to add a wholly unsupported extension to their illustrations. Continuing the example above, the Department asserts that the Illinois portion includes not only the distance from the Carrier's central office to the Illinois border, but also '...from the Illinois border to the first drop point and beyond.' *Id.* The TET statute provides for Taxation of charges for a private line's interstate inter-office channel 'provided *within Illinois*,' yet the Department's ruling position has been to expand this Taxation to a portion of the channel mileage that is *outside Illinois*. This position of the Department is directly contrary to the unambiguous language of the TET statute.

(c) *The Department's earlier error can be corrected*

There appears to be an explanation for the Department's error. Before the 1989 amendments to TET, there was no 'private line' exception to the general rule that the Tax is not apportioned. Thus, at that time, the Department was able to take a defensible position that some private line channel mileage beyond Illinois borders could be subject to the Tax. In a Private Letter Ruling issued while *Goldberg v. Sweet* (fn.5, above) was still wending its way through the judicial system and the constitutionality of TET was still in doubt, the Department issued 'interim' guidance, saying:

[The] Department will take the position with respect to a private line circuit that those portions of a private line which are *geographically within* the

State of Illinois *and any mileage from the State border to the first drop outside* the State would be considered mileage subject to tax ...

PLR 87-0333, *emphasis added*. While the Department took the position, in this 1987 ruling, that Illinois could tax some private line mileage beyond the Illinois border, it indicated that the apportionment question was not free from doubt at the time. Perhaps anticipating the 1989 legislative change that would ultimately create an explicit rule separately governing apportionment for private line mileage, the Department went on: 'We realize that the apportionment of private line revenues is significantly differently [sic] from the apportionment of general telephone usage circuits.'⁷ *Id.* This interim 'position,' announced so tentatively by the Department, was picked up again in PLR 88-0902, which also pre-dated the 1989 TET amendments.

After the 1989 law change, explicitly providing for private line apportionment to tax charges only for miles 'within Illinois,' the Department was asked whether it understood the new law to mean that Illinois was 'only interested in taxing interstate private line service to the state border?' The Department answered: 'Yes. The State is simply imposing its Telecommunications Excise Tax on that portion of the interstate channel service which occurs in Illinois or in which the State has nexus.' PLR 90-0824.

The issue became confused a few years later, however, when the Department appeared to interpret the current law with reference, not to PLR 90-0824 and the amended TET statute, but with reference to its Private Letter Rulings interpreting the pre-1989 law. In language that appears to be borrowed directly from PLR 87-0333 (interpreting the statute before the private line apportionment rule was added), the Department advised in a 1997 General Information Letter that 'Generally, the tax is imposed upon those portions of a private line which are geographically within the State of Illinois, *and any mileage from the State to the first drop outside the State* would also be considered mileage subject to the tax.' ST 97-0498-GIL, *emphasis added*. The Department repeated this anachronistic position a couple of years later in ST-99-0227-GIL.

The time has come for the Department to stop applying its pre-1989 positions to the post-1989 TET statute, and interpret that statute as it is currently constituted. The TET statute requires apportionment so that charges for a private line's interstate inter-office channel mileage are subject to tax only to the extent those miles are 'within Illinois.' Consequently, the TET statute should be interpreted by the Department as *not* applying to any mileage outside the Illinois border, and explicitly *not* applying to 'any mileage from the State to the first drop outside the State.'

2. Apportionment Must Be Calculated in a Mathematically Consistent Manner

The TET statute requires taxation only of the portion of gross charges attributable to private line interstate inter-office channel miles that are physically 'within Illinois,' but provides no guidance concerning how to calculate this apportionment. As a threshold matter, however, it must be noted that basic mathematical principles require that a

⁷ As noted above, there is no 'drop,' hand-off or switching point anywhere along Company's inter-office channel, other than the two termination points at Carrier's CITY central office and its STATE/CITY central office. If the Department were to persist in applying its pre-1989 analysis to the current statute, therefore, it would 'apportion' to Illinois the *entire length* of the interstate inter-office channel, from CITY to STATE/CITY.

fraction use the same units of measurement in both the numerator and the denominator, in order to produce a meaningful fraction.

This point may be illustrated as follows: A ratio of 3 square yards of blue fabric over 10 square yards of total fabric is mathematically consistent, leading to the conclusion that 30% of the fabric is blue. A ratio, however, of 3 yards of blue fabric over 5 pounds of total fabric is meaningless; it produces no usable fraction. The same unit of measurement must be used in both the numerator and the denominator.

3. Apportionment May Be Based on ‘Air Miles’ or ‘Route Miles,’ Not Flat Percentages or Inconsistent Fractions

Application of this ‘mathematical consistency’ requirement to TET allows two alternative approaches that, although they may yield different apportionment percentages, are equally justified. These two apportionment approaches are based on the two different units of measurement that may be used to determine the distance covered by an inter-office channel: air miles (straight line, ‘as the crow flies’) and route miles (following the actual physical path of the circuit).

(a) *Correct apportionment alternatives may produce different results*

The ‘Air Miles’ approach may be illustrated as follows: An apportionment ratio of 300 air miles in Illinois over 1000 total air miles (CITY to STATE/CITY, as the crow flies) would yield a conclusion under TET that 30% of the charges for that interstate inter-office channel should be subjected to Tax.⁸

The ‘Route Miles’ approach is likely to produce a different result. For the denominator of the fraction, total straight-line air miles inevitably will be shorter than actual physical route miles, because physical circuits cannot be laid across country in a straight line. For the numerator, however, Illinois air miles may be shorter or longer than route miles, depending upon whether the physical circuit exits Illinois at a point closer or farther than the point where a straight line from CITY to STATE/CITY leaves the state. To illustrate: The same channel that produced a 30% apportionment fraction under the ‘air miles’ method might produce a 25% fraction under the ‘route miles’ method, if the channel followed 325 physical route miles in Illinois and 1,300 total physical route miles from CITY to STATE/CITY.

In this illustration, apportionment of either 30% or 25%, based on either an ‘air miles’ ratio or a ‘route miles’ ratio, would be a justifiable conclusion under TET.⁹ Either approach enables a reasonable estimation of the ‘charges for that portion of the interstate inter-office channel provided within Illinois.’ 35 ILCS §630/2(a).

(b) *Carrier’s apportionment method violates TET*

Carrier applies a flat 50% apportionment to the charge for every interstate inter-office channel, regardless of actual mileage within Illinois and across the entire circuit. This method cannot be justified under TET because it does not provide a reasonable

⁸ Recall that only interstate inter-office mileage is apportioned, so the intrastate mileage between Company’s CITY location and Carrier’s central office (the ‘local access loop’) are not included in either the numerator or the denominator of this apportionment fraction.

⁹ As a practical matter, however, it may be far more difficult for a Carrier to calculate actual physical route miles of a channel than to use readily available air-miles charts.

estimation of the gross charges attributable to that portion of the channel provided within Illinois. Indeed, in the illustration above, where apportionment of either 30% or 25% would be correct, a 50% apportionment of charges would be grossly disproportionate.

If Carrier is required to abandon its 50% flat apportionment method, it might seek to apply other alternative methods currently in use by other carriers. In no event, however, would it be permissible to use a method (like that discussed at the text near footnote 4 above) that uses inconsistent units of measurement -- such as Illinois route miles over total air miles, or Illinois average miles-to-the-border over total actual miles from point to point. Like the nonsense 'fraction,' 3 yards of fabric over 5 pounds of fabric, an apportionment 'fraction' ostensibly measuring the ratio of route miles over air miles does not produce a mathematically meaningful result. Use of such an inconsistent fraction would also violate the TET statute's apportionment requirement for private lines.

REQUEST FOR RULING

For the reasons set forth above, we respectfully request, pursuant to 2 Ill. Adm. Code §1200.110, a Private Letter Ruling from your Department advising us that:

1. Only gross charges for the portion of private line inter-office channel miles that are physically inside Illinois borders may be subjected to TET.
2. TET apportionment of private line inter-office channel charges must use mathematically consistent units of measurement in the numerator and denominator.
3. Acceptable apportionment methods include 'Illinois air miles divided by total air miles' or 'Illinois route miles divided by total route miles.'
4. Unacceptable apportionment methods include flat percentages (e.g., 50%, regardless of actual distances in Illinois and across the entire channel) and fractions that use mathematically inconsistent units of measurement (e.g., 'IL route miles divided by total air miles').

We further respectfully request that the Private Letter Ruling recite the facts sufficiently to identify the private line service described above, so that we can present Company's case to Carrier, but that any published version be redacted to make the parties (including the names of Company and Carrier and other named carriers) anonymous.

To the best of the Company's knowledge, it is not the subject of a TET audit by the Department, nor is it pursuing litigation of any issue related to the TET. To the best of the Company's knowledge, the Department has not previously ruled (in either a Private Letter Ruling or a General Information Letter) on these issues for the Company or its predecessors in interest, nor has the Company or its predecessors in interest withdrawn any request for ruling on these issues.

Thank you for your kind attention to this request. If you find you cannot issue a favorable ruling at present, please contact me so we may withdraw this request. If you would simply like to discuss the issue further, please call me.

The Department's Responses

It should be noted that the Department has never before been asked to authorize the use of formulas to approximate the Illinois portion of private lines. As a result of your letter, we have been asked by at least one telecommunications provider for the opportunity to offer input into what formulas are to be authorized. For that reason, the Department will promulgate a regulation on this subject. The rulemaking process will give the opportunity for input to all telecomm providers and to all of their private line customers. Attempting to adopt formulas and make blanket statements about determining the Illinois portion of interstate inter-office channels only in the context of your request for a letter ruling gives a chance for input to only one customer of one telecomm provider. We are in the process of drafting that regulation and we will submit it as soon as possible. However, until a regulation is adopted dealing with the methods of applying the Illinois telecommunications excise tax to private lines, we make the following statements in response to your letter.

First, we think you are correct that the current Telecommunications Excise Tax Act does not authorize the imposition of the tax on charges for a portion of an interstate inter-office channel that is outside Illinois. The old letters you reference dated after the effective date of Public Act 86-905 that state that the tax can be imposed on charges for the distance of a private line from the Illinois border to the first out-of-state drop point are incorrect. We agree that section 2(a) of the Act contemplates that only gross charges for the Illinois portion of a private line are subject to Illinois telecommunications excise tax.

Second, the ideal method to calculate the Illinois portion of an interstate inter-office channel would be to determine a fraction, the numerator of which is the actual measured Illinois route miles of that channel and the denominator of which is the actual measured route miles of the entire channel. However, we understand it is not generally possible for telecomm providers to measure actual route miles of interstate inter-office channels. Since that is the case, it is necessary for telecomm providers to approximate the Illinois route miles and the route miles of the entire channel. We think that any method that accurately approximates the Illinois route miles of an interstate inter-office channel and accurately approximates the route miles of the entire channel can be used. Of course, the key is that the method must result in accurate approximations.

Third, we think that if it is not possible to determine actual route miles, the use of air miles would be appropriate so long as it did not result in an obvious distortion. As we understand the use of air miles, the straight-line air miles between the cities involved in the interstate inter-office channel would be determined from a standard air-miles chart. Then, in order to establish the Illinois portion of the channel, the air miles on the straight line from the Illinois city of the inter-office channel to the Illinois border would be used as the numerator and the straight line air miles between the two cities involved in the inter-office channel would be used as the denominator. We think this method is workable but it may not be appropriate to measure the Illinois portion of all private lines. Given the example of a private line from CITY to STATE/CITY, a Department auditor could not use this method if the telecomm provider could demonstrate that the first leg of the interstate inter-office channel went from CITY to somewhere in STATE and then south to STATE/CITY. In such a situation, the use of straight-line air miles between CITY and STATE/CITY would result in too many Illinois miles in relation to the entire private line.

Fourth, we are unable to make a blanket statement that it is never appropriate to mix route miles and air miles in determining the portion of the private line in Illinois. Your letter suggests that this will always result in a nonsense fraction that is akin to comparing 3 yards of fabric to 3 pounds of fabric. In situations where it is possible to approximate the entire channel only by air miles, we agree that it would be appropriate only to compare air miles to air miles. However, if the Department could demonstrate that the Illinois portion of an interstate inter-office channel meandered and the out-of-

state portion of that channel were more straight line, we do not see why the Department could not make an approximation of the actual Illinois route miles factoring in the Illinois meandering and an approximation of out-of-state miles using air miles. So long as the Department could articulate why the numerator and the denominator were accurate approximations of route miles, we think approximations based on Illinois route miles and out-of-state air miles could be used. In this situation, the numerator in the CITY to STATE/CITY example would be the approximation of Illinois route miles and the denominator would be the approximation of Illinois route miles plus the approximation using air miles from the Illinois border to STATE/CITY.

Fifth, we are unable to make a blanket statement that the use of a percentage to determine the Illinois portion of the interstate inter-office channel is always inappropriate. Again, so long as a telecomm provider can articulate a reason why the percentage is a reasonable approximation of the Illinois portion, we do not see why a percentage could not be used.

Sixth, we are able to make a blanket statement that the use of a flat percentage that is not an attempt to approximate the Illinois portion of the interstate inter-office channel is inappropriate under the statute.

I hope this information is helpful. If you have further questions concerning this Private Letter Ruling, please contact me at (217) 782-2844. If you have further questions related to the Illinois sales tax laws, please visit our website at www.revenue.state.il.us or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

George Sorensen
Deputy General Counsel for
Sales and Excise Taxes